Internal Revenue Service

memorandum

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Br1:JCAlbro

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to: District Counsel, Chicago CC:CHI
Attn: William T. Derick

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]

This is in response to your request for litigation advice dated March 8, 1991, concerning the above-mentioned case.

ISSUE

Whether the Service should litigate the issue of accrual in the loss year of state income tax refunds which become refundable due to net operating loss carrybacks, in light of Doyle, Dane, Bernbach v. Commissioner, 79 T.C. 101 (1982), 1988-2 C.B.1, nonacq.

CONCLUSION

We believe that under accrual accounting principles such refunds should be included in gross income in the year of the loss which gives rise to the refund. We disagree with the Tax Court's holding in Doyle, Dane, and we recommend continuing to litigate this issue.

FACTS

The relevant facts as set forth in the Appeals Supporting Statement are as follows. In [redacted], taxpayer filed a claim for refund of $[redacted] in state income taxes due to a net operating loss incurred in [redacted]. The expected refund was accrued as income in [redacted], when the refund was actually received. Taxpayer also determined that for taxable year [redacted], it was entitled to a refund of state income taxes in the amount of $[redacted], due to a net operating loss carryback. A refund claim was filed in [redacted], and a revised claim was filed in [redacted].

The revenue agent concluded that the taxpayer was required to accrue the refunds of state income taxes for the taxable years of the losses which gave rise to the refund claims, citing Rev. Rul. 69-372, 1969-2 C.B. 104.

DISCUSSION

In Doyle, Dane, taxpayer filed a claim for refund of state and city taxes based upon a net operating loss carryback from 1975. Respondent argued to the Tax Court that pursuant to Treas. Reg. § 1.451-1(a), by the end of taxable year 1975, all events had occurred which fixed taxpayer's right to receive the tax refunds and that the amounts could be determined with reasonable accuracy; thus, the anticipated refunds were includible in income in taxable year 1975. The Commissioner's position, that for Federal income tax purposes an accrual method taxpayer must include in income a refund of state or city taxes, resulting from a net operating loss carryback, in the taxable year of the loss effecting such a refund, is set forth in Rev. Rul. 65-190, 1965-2 C.B. 150 (New York taxes) and Rev. Rul. 69-372, 1969-2 C.B. 104 (Colorado taxes).

The Tax Court held that a refund of state and local taxes was not properly accruable in the year that the loss was incurred. The court's holding was partially based on what it saw as an inconsistency in Service position as reflected in Rev. Ruls. 65-190, supra, and Rev. Rul. 62-160, 1962-2 C.B. 139. Rev. Rul. 62-160 holds that interest on a refund of Federal tax accrues when a taxpayer's right to receive such a refund is ultimately determined; that is, the year that an authorized representative of the Service certifies the allowance of an overassessment in respect of the tax. The court, though professing not to dwell on the seeming inconsistency between the two rulings, because they were not binding on the court, nevertheless concluded that it was arbitrary for the Service to assert that it was reasonable to expect that a state would certify refunds (Rev. Rul. 65-190) but that it was not reasonable to expect that the Federal taxing authorities would ordinarily certify refunds (Rev. Rul. 62-160). In other words, if interest on a Federal tax refund generally does not accrue until the refund is approved by the Service, it follows that a state tax refund would not accrue until it is approved.

We believe that the Tax Court is wrong as a matter of law and that this issue should be litigated relying on relevant case precedents. With respect to the Doyle opinion itself, we believe that the court's concern with the inconsistent holding of Rev. Rul. 62-160 is an insufficient basis for its adverse opinion because that ruling is not factually on point to the issue in Doyle, Dane. More importantly, though, there are Supreme Court cases in the income accrual area which are relevant to the instant issue. Furthermore, the only case cited by the Tax Court in Doyle, Dane for income accrual principles is a Mississippi district court case. In Masonite Corp. v. Fly, 61-1 U.S.T.C. ¶ 9355 (S.D. Miss.,1961), the

district court held that an accrual method taxpayer's right to a refund of Mississippi income taxes was not fixed until the Mississippi Attorney General, who had discretion to approve refund claims, did in fact make such approval.

In Masonite, taxpayer filed a claim for refund of state income taxes. By the end of the taxable year at issue, the State Tax Commissioner and the State Auditor had favorably acted upon the claim. The Attorney General's office, though, had not taken action to approve the claim. The district court held that the right to the refund was conditional and contingent until the refund claim was approved by the Attorney General. The court viewed the Attorney General's powers as discretionary, not ministerial, relying on his powers to require additional documentation to support the claim and to approve it only if he believed it complied with state law on income tax refunds.

The Masonite court's view of what constitutes a condition or contingency sufficient to hold that a right to accrue income or deductions is not fixed has changed in recent years. Two recent Supreme Court cases, United States v. Hughes Properties, 476 U.S. 593 (1986) and United States v. General Dynamics, 481 U.S. 239 (1987) defined the all events test for accruing liabilities under section 461. The same "all events" test principles of course, apply to determine when income must be accrued.

In Hughes, at issue was taxpayer's accrual of jackpot liabilities on progressive slot machines. The Commissioner's position was that the jackpot liabilities were not fixed but rather were conditional until a patron made a winning handle pull, notwithstanding that the liability on the machine was fixed and irrevocable under Nevada law. For example, the casino could go out of business, and would never have to pay the alleged accrued jackpots. The Court held that the liabilities were not contingent, 476 U.S. at 601-02. The remote and speculative possibilities that a jackpot might not be won did not alter the fact that the liabilities were fixed as a matter of state law.

In General Dynamics, at issue were accrued liabilities for employee medical benefits. The Court held that the all events test was not met upon the receipt of medical services by employees. A fixed liability did not occur until employees filed claim forms. The claim forms were reviewed for proper documentation and proof of charges, and the taxpayer could request additional information to support any claim. An important point with respect to the instant case is that the Court, 481 U.S. at 244, fn. 4, accepted the lower court's factual conclusion that the processing of claims was routine, clerical and ministerial in nature. We note that factually the

review and processing of medical benefit claims probably involves a similar process to that for state tax refunds. We believe that both Hughes and General Dynamics undercut the Masonite opinion. Furthermore, they support the position that there are no contingencies in your case sufficient to delay income accrual of the state tax refunds beyond the loss year. We note, of course, that taxpayers may reasonably argue that pursuant to General Dynamics, all events have not occurred to fix the right to the state tax refund until the refund claim is filed. In your case, such an argument would delay the income accrual for taxable year [redacted]. Such an argument may be rebutted by the fact that once a net operating loss carryback exists, filing a tax refund claim and its processing are both ministerial acts. Hinging income accrual on the year that a refund claim is filed would also enable taxpayers to control the year in which income must be accrued.

If taxpayers raise the General Dynamics argument with respect to taxable year [redacted], we suggest that you request further litigation advice. We plan to write to Technical in the near future and request their views on how Service position in Rev. Ruls. 65-190 and 69-372 is affected by the General Dynamics all events test claims filing requirement.

We believe that the holding of Rev. Ruls. 65-190 and 69-372 are correct statements of income accrual principles except, of course, for the General Dynamics caveat, which may present litigation hazards for [redacted].

Pursuant to our revenue rulings, when a taxpayer incurs a loss, the loss is calculated and the resulting decrease in tax properly accrues when the loss was incurred. There is no reason to distinguish between a reduction in tax when a loss is deducted against a current year's income and a reduction in an earlier year's tax liability when a net operating loss is carried back. Notwithstanding the unresolved inconsistency in the revenue rulings discussed in Doyle, Dane, we believe that income accrual principles in case law support continuing to litigate this issue.

Treas. Reg. § 1.451-1(a) provides that an accrual method taxpayer must accrue income when all events fixing the right to such income have occurred and the amount can be determined with reasonable accuracy. Where a net operating loss is sustained for a particular year, the amount of the loss can be calculated with reasonable accuracy from the books and accounts of the taxpayer. Rev. Ruls. 65-190 and 69-372 state that accrual basis taxpayers must include in income state and local tax refunds resulting from NOL carrybacks in the year in which the tax loss occurred. The filing and review of the state refund claims by the various governmental authorities are viewed as ministerial procedures that do not defer the accrual of the

refunds. A loss is the event which fixes the taxpayer's right to a refund, and government processing of a claim is ministerial. See Continental Tie and Lumber Co. v. United States, 286 U.S. 290 (1932); United States v. General Dynamics, supra.

For a taxpayer using an accrual method of accounting, it is the right to receive an item of income and not the actual receipt that determines the inclusion of the amount in gross income. Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934). No income, however, accrues during the tax year if the right to receive the income is contingent upon future events or is substantially in controversy. For an accrual method taxpayer, the refund of taxes is includible in income in the year in which all the events have occurred to fix the right to receive the refund, which is the year of the event triggering the refund.

The fact that the claim for refund is subject to review by state governmental authorities does not alter the proper year of accrual. In Continental Tie & Lumber Co. v. United States, 286 U.S. 290 (1932), the taxpayer-railroad was entitled to an award from the Interstate Commerce Commission under the terms of section 204 of the Transportation Act of 1920, 41 Stat. 456. The award was compensation for the period during which the Federal government operated the railroad during the First World War. The Act provided the standards to be applied in computing the award, although the granting of each award was subject to review by the Commission. The Court labeled the function of the Commission as "ministerial," and held that the right to the award was fixed by passage of the Act. The taxpayer had contended that the Commission's power was discretionary, and the amount of any award depended on many contingencies. The Court disagreed and stated that all that remained was a mere administrative procedure to ascertain the amount to be paid. The test applied by the Court to determine whether it was proper to accrue the award was "whether the taxpayer has in its own books and accounts data to which it could apply the calculations required by the statute and ascertain the quantum of the award within reasonable limits." 286 U.S. at 296. The Court held that the award was properly accrued when the Act was passed.

At the close of a loss year, a taxpayer's books and records contain sufficient data from which an accruable amount can be determined with reasonable accuracy and a properly documented state claim form can be filed. The fact that the refund amount finally determined may be different does not delay accrual. See Continental Tie & Lumber Co. The taxing statutes provide the standards to compute the refund and file an accurate claim. The review of the subsequent refund applications by the various state governmental authorities do

not constitute contingencies resulting in the deferral of the accrual of income. Instead the processing of state refund claims are ministerial procedures that enable the state and local authorities to ascertain the accuracy of the taxpayer's application and do not impact upon the accrual.

In summary, consistent with the principles contained in Continental Tie and assuming that the processing and approval of state income tax refund claims may be realistically characterized as ministerial rather than substantive, we believe that we should continue to litigate the Doyle, Dane issue. It is our position that the anticipated refund is income in the loss year, not in the subsequent year when a refund is approved by state or local authorities. We believe that approval of claimed refunds may reasonably be expected and such approval is a ministerial act, not a substantive contingency sufficient to delay accrual. Even if the amount actually refunded differs somewhat from the amount in the refund claim, accrual need not be delayed as long as the amount of the claimed refund was estimable with reasonable accuracy. Therefore, in your case, we should take the position that income is accruable in [redacted] and [redacted].

If you have any further questions, please contact Joyce C. Albro at 566-3442.

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